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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:CORP:B06 – PLR-143576-03

Date:

December 04, 2003

Legend

Taxpayer	=
LLC B	=
State A	=
<i>a</i>	=
<i>b</i>	=
<i>c</i>	=
<i>d</i>	=
<i>e</i>	=
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<i>p</i>	=
Date 1	=
Date 2	=

Dear

This letter responds to your representative's letter, dated July 15, 2003, requesting a ruling that pursuant to §1032 no gain or loss shall be recognized by the Club from the Founder Members' membership contributions received in exchange for equity interests of the Club. You submitted additional information in a letter dated December 2, 2003. The material information submitted for consideration is summarized below.

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Taxpayer (hereinafter the "Club") was incorporated in State A on Date 1 as a membership nonprofit corporation. It is a non-exempt organization for federal income tax purposes and is subject to § 277 of the Internal Revenue Code. Additionally, it is an accrual-method taxpayer that keeps its books and records on a calendar-year basis.

The Club was formed to own, operate and maintain a private golf course and club facilities located in State A. Its facilities will consist of (1) a golf course; (2) related facilities, such as a driving range, putting green and short game practice area; (3) a clubhouse featuring a dining/grill room, pro shop and men's and women's locker rooms; (4) a golf maintenance facility; and (5) a cart barn.

The Club will be member-owned, with a maximum of *a* equity members. It will primarily offer two classes of equity membership: Founder and Regular. It will make an initial offering for a maximum of *b* Founder Members for an initiation fee of \$*c*. There will also be a small number of other memberships.

The Club will use the proceeds from the Founder Member offering (estimated to be about \$*h*) to purchase land upon which the golf course will be located and to construct the club facilities. It anticipates that it will use the proceeds from the Regular Member offering to purchase land, additional capital requirements, establish reserves, and possibly to make refunds to Founder Members. All (i.e., equity and nonequity) members are required to pay monthly dues. Presently dues are budgeted to be \$*d* per year or \$*e* per month.

Equity members are entitled to use all of the club facilities. They will not be required to pay green fees for use of the golf facilities, but will be required to pay golf cart fees. They will also be entitled to reserve golf starting times. Other members (i.e., nonequity members) will have the same access to club facilities as equity members and will also not be required to pay greens fees. Such members will be required to pay monthly dues, cart fees, golf cart fees and other applicable fees required of equity members.

An immediate family member of a member will be entitled to use the club facilities on the same basis as the member; however, the Club reserves the right to modify or terminate this privilege at any time. All members will be encouraged to invite guests to use the club facilities upon payment of the applicable guest charges.

The Club will be governed by a board of directors, which will initially be appointed by LLC B. After *f* years, the equity members will elect all members of the board of directors, who must all be fellow equity members. The board of directors will be composed of *g* members. The board of directors will have the authority, among other things, to set the membership contribution for an equity membership, set the amount of

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dues, fees and charges to be paid by members and levy operating assessments if required.

The equity members will be entitled to the following voting rights: (1) to elect the Club's board of directors, (2) amend the Club's Articles of Incorporation; (3) amend the Club's Bylaws, (4) dissolve the Club, (5) merge the Club with another entity, (6) convert the Club to another form of entity, (7) sell the Club's assets, other than in the regular course of activities, and (8) dissolve the Club. Additionally, a majority of the equity members must vote in favor of any proposed capital or special assessment, and such approved assessments will be prorated equally among the equity members. Each equity member is entitled to one vote on matters submitted to a vote of the equity members.

Upon the Club's dissolution, all of the Club's property and assets (after payment of its debts) will be liquidated and distributed as provided under State A law among all of the then existing equity members.

Founder Members will be entitled to the following special benefits not available to other equity members: (1) recognition at the Club as a "Founder Member," (ii) the ability to participate in an annual Founder Member Golf Tournament; and (iii) a 20% discount on pro shop merchandise. Founder Members may also receive a contingent benefit solely based upon future sales, if any, of Regular Memberships. Such a benefit will be made through a reduction in dues for a specified period of time. For every k equity membership sold, commencing with the m^{st} equity membership issued in the Club, Founder Members will pay $k\%$ of the dues payable by Regular Members for a period of n years. The amount of this benefit will be reported to the Founder Members on a Form 1099 when, and if, realized.

Equity Memberships are not transferable on the open market, but may be transferred through the Club. The Club will be obligated to transfer the membership only after an individual acceptable to the Club has paid the required membership contribution and has been admitted as a replacement member. If a member resigns his membership, the Club will place the member's resigned membership on a waiting list and it will be reissued on a first-resigned, first reissued basis.

A member who owns a home in the vicinity of the Club may arrange for the Club to transfer his membership to the subsequent purchaser of his home and he does not have to have his resigned membership placed on the resigned membership waiting list. The Club will be obligated to so transfer the membership but only upon the approval of the subsequent purchaser for membership and the payment of the required current membership contribution. Upon death of a member, the deceased member's membership will automatically pass to the surviving spouse. If there is no surviving

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spouse or if the surviving spouse does not elect to continue the membership privileges, the Club will reissue the membership in the same manner as a resigned membership.

Upon reissuance of a resigned equity membership, the resigned member will be entitled to receive a refund equal to $i\%$ of the amount of the membership contribution then charged by the Club for an equity membership. The Club can deduct from the amount of the refund any amount which the member owes the Club.

The Club will not purchase the land or commence construction of the Club unless and until a total of b Founder Memberships have been sold. Until such time, all contributions will be held in an escrow account. If all of the Founder Memberships are not sold and paid for by Date 2, all Founder Member membership contributions will be returned to the prospective Founder Members without interest. However, if p Founder Membership deposits have been received by Date 2, the date at which all Founder Memberships can be sold and paid for can be extended.

The Club makes the following representations:

- a. The membership contributions by Founding Members will not be paid for goods or services or the use of the property. Specifically, these contributions will not be paid for the general use of the club, the ground fees, the use of golf carts, or items of a similar nature.
- b. The Founding Members' membership contributions are earmarked for capital expenditures; specifically, they are earmarked for the purchase of land upon which the club facilities will be located and to construct the club facilities.
- c. The Founding Members have the opportunity to profit from their membership contributions.

The Club requests the ruling that: pursuant to §1032 no gain or loss shall be recognized by the Club from the Founder Members' membership contributions received in exchange for equity interests of the Club.

Section 1032(a) provides in part that no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.

Treas. Reg. §1.1032-1(a) provides in part that the disposition by a corporation of shares of its own stock (including treasury stock) for money or other property does not give rise to taxable gain or deductible loss to the corporation regardless of the nature of the transaction or the facts and circumstances involved.

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Whether a corporation has received money or other property "in exchange for stock" for purposes of §1032(a) is determined based on the following 2-prong test: (1) whether the transferor received a significant proprietary or equity interest in the corporation; and (2) the transferor's motive or intent for the transfer of the money or other property. See Affiliated Gov't Employees' Distributing Co. v. Commissioner, 322 F.2d 872, 877 (9th Cir. 1963), cert. denied 376 U.S. 950 (1964); Rev. Rul. 81-83, 1981-1 C.B. 434.

Whether a transferor obtains an equity interest in a corporation is determined by examining the rights accompanying the stock received. Rev. Rul. 81-83, supra. The same substantive analysis is applied to membership interests in those cases where traditional stock is not present. In general, an equity interest implicates three basic rights: (1) the right to vote and thereby to exercise control; (2) the right to participate in current earnings and accumulated surplus; and (3) the right to share in net assets on liquidation. Paulsen v. Commissioner, 469 U.S. 131, 138 (1985); Himmel v. Commissioner, 338 F.2d 815, 817 (2nd Cir. 1964).

Here, each equity member is entitled to one vote on matters submitted to a vote of the equity members. Equity members will vote: (1) to elect the Club's board of directors; (2) to amend the Club's Articles of Incorporation; (3) to amend the Club's Bylaws; (4) to dissolve the Club; (5) to merge the Club with another entity; (6) to convert the Club to another form of entity; (7) to sell the Club's assets, other than in the regular course of activities; and (8) to liquidate the Club. In addition, a majority of the equity members must vote in favor of any proposed capital or special assessment. Here, the equity members have a right to vote and thereby exercise control of the Club.

Equity members do not have the right to participate in the Club's current earnings and accumulated surplus. Under the State A's nonprofit laws, a State A nonprofit corporation is not permitted by law to pay dividends to members.

Equity Members do have the right to share in net assets on liquidation. Upon dissolution or liquidation of the Club, after payment of debts, the equity members are entitled to receive the Club's remaining assets in proportion to their capital contributions. The equity members possess rights in liquidation that are proportionate to their capital contributions.

Thus, an equity member possesses 2 of the 3 basic rights of a traditional shareholder. The only right which a shareholder typically enjoys that the equity member here does not is the right to share in current earnings and accumulated surplus. Nonetheless, to the extent the equity members share in the Club's assets on liquidation, their ultimate equity ownership in the club's assets is unaffected. See Lake Petersburg Ass'n v. Commissioner, T.C. Memo. 1974-55. Here, upon the Club's dissolution or liquidation,

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all of the Club's property and assets, after payment of the Club's debts, will be liquidated and distributed among all of the then existing equity members.

Moreover, the equity members are to be the Club's only owners, there will be no others. Minnequa University Club v. Commissioner, T.C. Memo. 1971-305 ("While the petitioner is a nonstock corporation, its members are its only owners and must be put in the shoes of stockholders"). Also, the equity memberships, like shares of stock, are effectively transferable. Accordingly, for all the above reasons, we conclude that the equity members possess more extensive rights than just the right to play golf or otherwise enjoy the club facilities and therefore are in the nature of shareholders with respect to the Club. See Lake Petersburg Association v. Commissioner, *supra* ("The regular members did possess more extensive rights than those of a lessee . . . we conclude that the regular members were in the nature of shareholders").

Since the ruling requested is for a conclusion that under §1032(a) no gain or loss from Founder Member membership contributions will be recognized, we need also determine whether these contributions qualify as payments to the Club for goods and services or as payments for equity interests in the Club. Section 1032(a) requires that the payments be made as investments in the capital of the corporation, rather than in consideration of goods or services. Affiliated Gov't Employees' Distributing Co., 322 F.2d at 877. Although no court has yet set forth a test for determining "investment motive" under §1032(a), the test for investment motive developed in the context of shareholder contributions to the capital of a corporation under §118(a) is relevant.

In Board of Trade v. Commissioner, 106 T.C. 369 (1996), wherein the issue was whether a payment of transfer fees constituted a §118(a) shareholder contribution to capital, the Tax Court noted that a member-owner's receipt of goods or services from the corporation does not in itself negate a contribution to capital. *Id.* at 379. Rather, the test is whether the payor, in making the payment, had an investment motive. *Id.* at 381. The Tax Court specified the following three factor test to be applied in determining whether an investment motive exists: (1) whether the fee is earmarked for application to a capital expenditure; (2) whether the payors are the equity owners of the corporation and the payment increases the corporation's equity capital; and (3) whether the members have the opportunity to profit from their investment in the corporation. *Id.* at 379. If these factors are present, one can safely conclude that the Founding Members have an investment motive in paying the \$c initial contribution amount.

Earmarking is defined as setting aside funds for application to a capital acquisition or expenditure. Board of Trade, 106 T.C. at 386. Here, the Club represents that the Founding Members' membership contributions are earmarked for capital expenditures. Specifically, the Club represents that these contributions are earmarked for the purchase of land upon which the club facilities will be located and the construction of the

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Club. It further represents that these contributions will not be paid for goods or services or the use of the property. Specifically, they will not be paid for the general use of the club, the ground fees, the use of golf carts, or items of similar nature. Accordingly, we conclude that the Founder Members' membership contributions are earmarked for application to capital acquisitions or expenditures.

Here, the equity of the Club as well as the equity interests of the Founding Members will increase as a result of the Founding Members' membership contributions. Again, the Founding Members' membership contributions are earmarked to be used only to purchase the land and to construct the Club. The purchase of the land, as well as the construction of a golf course and a club house on the land, will clearly enhance the Founding Members' equity interests in the Club. Furthermore, assuming that the Club sells all of the offered Founder Memberships, the amount of the proceeds from such an offering (\$*h*) will constitute a significant equity interest in the Club. Accordingly, it follows that the Club's receipt of \$*h*, the proceeds from the initial offering of Founder Memberships, will significantly increase the equity of the Club as well as the Founding Members' equity interests as a whole.

Here, also, the Founding Members have the opportunity to profit from their membership contributions. As a general proposition, the ability to sell an interest in a corporation permits an equity holder to profit from any appreciation in the investment. See Board of Trade, 106 T.C. at 390 (the free transferability of membership interests was viewed as evidence that payors of transfer fees had the opportunity to profit from appreciation in their investment). The Club represents that the Founding Members have the opportunity to profit from their membership contributions. Such memberships are effectively transferable.

The Club will establish a redemption mechanism that enables the Founding Members to sell their memberships and potentially profit thereby. Specifically, upon the death, resignation or expulsion of a Founding member, the Founding Member is entitled to receive a refund equal to *P*% of the amount of the membership contribution then charged by the Club for an equity membership. Although the Club is in its inception phase and can depend on no history to support its representation that a Founding Member can profit from his membership contribution, nonetheless, considering the popularity of golf as a sport and the location of the Club (State A), we believe that equity membership fees can rise resulting in a Founding Member's receipt of a refund payment equal to or greater than his initial membership contribution.

We note that the prospect of a Founding Member receiving a refund for his equity interest in the Club is conditioned upon the Club approving another candidate for Regular membership and the approved candidate paying the required capital contribution. Nonetheless, we do not think that these 2 conditions are significant

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obstacles to the Founder Member's ability to receive a refund. Accordingly, we therefore conclude that Founding Members have the opportunity to profit from their membership contributions.

In conclusion, we hold that (i) a Founding Member will receive a significant equity interest in the Club in exchange for the payment of the Founding Member's membership contribution; and (ii) the Founding Member will make the payments with an investment motive.

Moreover, a Founder Member's membership contribution is not an amount directly related to the amount and number of services provided or uses of the club facilities provided to members. An indication of whether a payment is for goods or services is whether the amount of the payment is directly related to the amount and number of services provided, or merely incidental thereto. Board of Trade v. Commissioner, 106 T.C. 369, 380 (1996). Here, the purchase price of a Founder Equity membership (\$c) has no quantifiable correlation with the amounts or extent of the functions performed or services rendered by the Club. Each Founder Member pays the same purchase price for his membership regardless of how frequently or infrequently he uses of the Club or its facilities. Furthermore, each member pays monthly dues for the right to use the Club facilities. It is reasonable to assume that some Founder Members will make substantially more use of the Club and its facilities than other Founder Members. Nonetheless, the purchase price of a Founder Member membership is the same for both, therefore we conclude that the Founder Member's membership contribution amount is not correlated to the frequency of use of the Club or the facilities.

Based on the foregoing analysis, the information submitted, and the representations made by the Club, we rule that: pursuant to §1032 no gain or loss shall be recognized by the Club from the Founder Members' membership contributions received in exchange for equity interests of the Club.

The rulings contained in this letter are based upon information and representations submitted by the Club and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed: (1) regarding amounts received by the Club from its members for services which the Club renders to its members; (2) on the tax consequences from the discounts to be given to the Founder Members with regard to their monthly club dues; (3) on the tax consequences from the 20% discounts on purchase of pro shop merchandise to be given to equity members; (4) regarding the

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character of any income to the equity members; and (5) whether the Club is subject to §277 of the Code.

This ruling is directed only to the Club(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant.

Sincerely,

Steven J. Hankin

STEVEN J. HANKIN
Senior Technician Reviewer, Branch 6
Office of Associate Chief Counsel
(Corporate)

cc: